* Together with:
Church of Christ, Ecorse, Mich. v. Nat. Plan. No. 391

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1968

NO. _____

NATIONAL PLAN, INC., et al,

Petitioners,

v.

CHURCH OF CHRIST OF ECORSE, MICHIGAN, et al,

Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

TO THE HONORABLE CHIEF JUSTICE AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

Petitioners, National Plan, Inc. and Robert H. Knox,

pray that a Writ of Certiorari issue to review the order and judgment of the United States Court of Appeals for the Fifth Circuit entered in that Court in the above entitled case, reversing in part the judgment of the United States District Court for the Northern District of Texas, Dallas Division, sitting at Dallas, Texas.

OPINIONS BELOW

The opinion of the Court of Appeals, reported in 391 F. 2d 357 is attached hereto as Appendix B. The unreported findings of fact and judgment of the District Court are attached hereto as Appendix A.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit sought to be reviewed was dated and entered on the 12th day of March, 1968. Petitioners' Petition for Rehearing was denied by Order dated and entered April 12, 1968.

Jurisdiction to review said judgment by Writ of Certiorari is believed to be conferred on the Supreme Court by the provisions of Title 28, U. S. Code, Section 1254(1).

QUESTIONS PRESENTED

The following important questions involving con-

struction and application of provisions of the Securities Exchange Act, 15 U.S.C. §§78a-78hh-1, are present in this case:

1. Do issuers who utilize the services of an unregistered broker-dealer in selling securities possess a cause of action against a purchaser, an unregistered broker-dealer, solely because of the purchaser's failure to comply with the registration requirements of the Securities Exchange Act in the absence of causal connection between the failure to register and the issuers' loss?

2. If issuers are entitled to rescind sales under the foregoing circumstances, must they restore to the purchaser consideration paid to the issuers' authorized agent?

3. Is the defense of *pari delicto* available to the purchaser because of false representations in the securities or the failure of issuers' agent to comply with such registration requirements?

All of these questions were decided adversely to Petitioners by the Court of Appeals.

STATUTES AND REGULATIONS INVOLVED

This case involves the Securities Exchange Act § § 10, 15(a)(1), 28(a), 29(b) and 29(c); 15 U.S.C. §78j, o(a)(1), bb(a), cc(b) and cc(c) and Regula-

tion 10b-5, 17 C.F.R. § 240. 10b-5 which are set out at length in Appendix C.

STATEMENT OF THE CASE

Respondents and other church corporations issued negotiable bearer bonds and sold them or furnished them to be sold to Paden, a building contractor. Each bond recited on its face that the issuer had received payment in full and that the bond would be negotiated by delivery. Paden failed to pay for many of the bonds, and suit was filed against Paden and others to recover the bonds or their value.

Paden, though not registered as a broker-dealer as required by the Securities Exchange Act, acted in the capacity of either principal in selling the bonds for his own account or as agent of the issuers.

Petitioner National Plan, Inc., an unregistered broker-dealer, purchased a number of these bonds; it intervened in Respondents' suit and sought a declaratory judgment that its bonds were valid and subsisting obligations of the issuers and that it was a holder in due course.

Respondents raised certain defenses and sought affirmative relief against Petitioners for fraud, conspiracy and violation of the Securities Laws.

The District Court and the Court of Appeals ruled

against Respondents on all counts, except the Appellate Court held that the transactions in which Paden acted as agent for the issuers were void ab initio for the reason that Petitioners had failed to register as broker-dealers.

Despite the absence of causal connection between such failure and the loss to the issuers, the Court of Appeals held that Respondents could recover either the bonds or their damages without restoring to Petioners the consideration paid for the securities to Respondents' agent, who was authorized to sell the bonds and collect the sales proceeds. The sole reason given for this radical departure from precedent: "The harsh remedy which this view dictates, even where the churches chose the unfaithful agent, *seems to be what Congress intended.*" (391 F. 2d at page 362).

The fundamental question which underlies this dispute may be stated simply: *Should an issuer of negotiable bearer bonds which delivers them to another with authority to sell bear the risk of misapplication of the proceeds of sale?*

In order to determine this issue, the questions set out above involving construction of the Exchange Act must be answered.

How a Federal Question is Presented:

Respondents' complaint is based upon the Securi-

ties Exchange Act. All questions pertinent to review of the decision of the Court of Appeals involve interpretation of that Act.

These important questions of federal law have not been, but should be, decided by the Supreme Court.

REASONS FOR GRANTING THE WRIT

The decision of the Court of Appeals was based upon a strict and mechanistic interpretation of § 29(b) of the Exchange Act which, as that Court recognized in its opinion, resulted in a harsh remedy.

It ascribes to Congress an intent inconsistent not only with extant legal principles but also with the history of the Exchange Act in Congress and the decisions of other Courts of Appeals.

Although Petitioners are described by the Court of Appeals as "innocent parties", not guilty of fraud or conspiracy as charged by Respondents, the decision invokes against them a remedy more harsh than that with which a party guilty of fraud would be burdened.

The embezzlement of Respondents' funds by their agent was not facilitated by any act or omission of Petitioners. The proximate cause of any loss of Repondents was the entrustment of their negotiable bonds to a dishonest agent. The failure of Petitioners

to register had no connection with the defalcations of Respondents' agent.

The interpretation placed upon § 29(b) of the Exchange Act which would permit Respondents to rescind the sales, which Paden had actual authority to make, and to recover their bonds without restoring to Petitioners the consideration paid, is unreasonable and oppressive.

Such construction of the statute should be set aside, and a correct and reasonable construction should be adopted by this Court. *Burnet v. Guggenheim*, 288 U.S. 280, 285, 77 L.Ed. 748, 751, 53 S.Ct. 369.

ARGUMENT AMPLIFYING REASONS RELIED ON FOR ALLOWANCE OF THE WRIT

1. *Do issuer who utilize the services of an unregistered broker-dealer in selling securities possess a cause of action against a purchaser, an unregistered broker-dealer, solely because of the purchaser's failure to comply with the registration requirements of the Securities Exchange Act in the absence of causal connection between the failure to register and the issuers' loss?*

The only "wrong" committed by Petitioners was the failure to register as a broker-dealer as required by § 15 of the Exchange Act, 15 U.S.C. § 78o(a)(1).

The District Court found that "... if any violation occurred ... any such violation did not materially deny to plaintiff churches any protection which the securities laws were designed to afford." (Appendix A, p. _____).

Recognition of the necessity of proof of causation —that the statutory violation is a legal cause of the injury complained of—is found in numerous cases. *Baird v. Franklin* (CA 2, 1944) 141 F. 2d 238, 245; cert. den., 323 U.S. 737, 89 L.Ed. 591, 65 S.Ct. 38; *Downing v. Howard*, (CA 3, 1947) 162 F. 2d 654, 657-658, cert. den. 332 U.S. 818, 92 L.Ed. 395, 68 S.Ct. 155; *Dann v. Studebaker-Packard Corp.* (CA 6, 1961) 288 F. 2d 201, 213.

In *J. I. Case v. Borak*, 377 U.S. 426, 12 L.Ed. 2d 423, 431-2, 84 S.Ct. 1555, 1559, this Honorable Court recognized the necessity for such causal relationship. It is further discussed at length in the well-reasoned opinion in *Barnett v. Anaconda Company*, (S.D. N.Y. 1965), 238 F. Supp. 766, 770-773.

Although the Court of Appeals states that it has found no case in point, it cites, as supporting its holding that there is no necessity for causal connection between the violation of a statute and the loss incurred by the complaining party, the case of *Goldstein v. Groesbeck*, (CA 2, 1944) 142 F. 2d 422, cert. den. 323 U.S. 737, 65 S.Ct. 36, 89 L.Ed. 590, and its own

prior decision in *Hooper v. Mountain States Securities Corporation* (1960), 282 F. 2d 195, 200-202.

These are in conflict with other decisions of Courts of Appeals to the extent that the element of causation has been eliminated.

List v. Fashion Park (CA 2, 1965) 340 F. 2d 457, is a later case by the Court which decided *Goldstein v. Groesbeck*, supra. Although speaking in terms of the necessity of "reliance" rather than causation, it is clear that the Court denies relief because of the failure of a causal connection between the defendant's conduct and the plaintiff's injury. The Court uses the concept set out in Restatement, Torts § 546 and tort treatises, all of which recognize causation as essential to recovery. In refusing to eliminate this element, the Court states at page 463 of its opinion:

> "Assuredly, to abandon the requirement of reliance would be to facilitate outsiders' proof of insiders' fraud, and to that extent the interpretation for which the plaintiff contends might advance the purposes of Rule 10b-5. But this strikes us as an inadequate reason for reading out of the rule so basic an element of tort law as the principle of causation in fact."

The same Court in *Vine v. Beneficial Finance Co.*, 374 F. 2d 627, 635, cert. den. 389 U.S. 970, stated:

> "What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury."

And in *Smith v. Bear*, 237 F. 2d 79, 88 this same Court stated that a violation permits the injured party to recover ". . . any loss proximately resulting therefrom."

In view of these later decisions, the isolated holding in *Goldstein v. Groesbeck*, supra, is entitled to no weight.

The requisite causal connection was found absent in *Boone v. Baugh* (CA 8, 1962) 308 F. 2d 711, where the use of interstate commerce occurred after consummation of the questioned sales.

Respondents claim for damages is a claim sounding in tort. It is one of the claims characterized by courts as "implied" by the securities laws. There is no basis for the implication of such a tort action in the absence of the essential element of causation which pervades the whole of tort law.

It is stated in the American Law Institute's Restatement of Torts, § 286:

> "The violation of a legislative enactment by doing a prohibited act, or by failing to de a re-

quired act makes the actor liable for an invasion of an interest of another if:

(a) the intent of the enactment is exclusively or in part to protect an interest of the other as an individual, and

(b) the interest invaded is one which the enactment is intended to protect; and

(c) where the enactment is intended to protect an interest from a particular hazard, the invasion of the interests [sic] results from that hazard; and

(d) the violation is a legal cause of the invasion, and the other has not so conducted himself as to disable himself from maintaining an action."

In connection with the holding of the Court of Appeals that Congress seems to have intended that no proof of causation be required in actions for damages for violation of the Exchange Act, counsel for Petitioners has read the entire reported debate in Congress and the reports of the Congressional Committees which considered this Act during its formative stages. It nowhere appears that Congress specifically addressed itself to this particular subject or examined in this statutory context even the broad issue presented in this case. However, in discussing the analogous question of liability for false and mislead-

ing statements, Congress clearly intended that there be no liability in the absence of causation, i.e., reliance upon the false statement.

Mr. Sam Rayburn, Chairman of the House Committee on Interstate and Foreign Commerce, in debate stated at p. 7,701, Congressional Record, Vol. 78 73rd Cong. 2d Session:

> "The first provision of the bill as originally written was very much challenged on the ground that reliance should be required. This objection has been met. In other words, if a man bought a security following a prospectus that carried a false or misleading statement, he could not recover from the man who sold it to him, nor could the seller be punished criminally unless the buyer bought the security with knowledge of the statement and relied upon the statement. It seemed to us that this is as little as we could do."

Thereafter, in debate which appears at page 8,039 of the Congressional Record it is stated:

> "Mr. Hollister:
>
> Does the gentleman believe that whenever a man is damaged he has a right to sue somebody for damages, no matter how responsible the person sued may be for the injury?

Mr. Rayburn:

If they are responsible for the damage by false and misleading statements, yes.

Mr. Hollister:

Even if the statements are innocently made.

Mr. Rayburn:

If the statements are made in good faith, he is not responsible."

The continued discussion shows that, at most, Congress contemplated a shifting of the burden of proof and not absolute liability without causation.

Consistent with this interpretation of Congressional intent is the amendment to the 1933 Act adopted in the same bill in which the 1934 Act was passed.

At p. 10,186 Congressional Record Vol. 78, 73rd Cong. 2d Sess., in debate, Senator Byrnes stated:

"Under the existing law, the plaintiff is entitled to recover the amount of the loss suffered by him as a result of the purchase and sale of the security. Under the new law, the defendant will have the right to show whether a part of the plaintiff's loss is due to some cause other than the untrue statement, and to such extent will be

able to reduce the amount of the recovery by the plaintiff . . ."

The Court of Appeals did not comment upon the compeling requirement of Section 28(a) of the Exchange Act (15 USC § 78bb) that ". . . no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in *one* or more actions, a total amount in excess of his *actual damages on account of the act complained of.*" (Emphasis added).

Legislative intent to require causation could not be expressed more clearly.

The requirement of registration was a mere technicality or formaliy. Petitioners' failure to comply with the requirement had nothing to do with the consummation of the transactions in question or any loss on the part of Respondents.

The contention that there is no requirement of "causation" is contrary to settled principles of law.

Similar reasoning, if applied to Respondents' violation of Section 10b of the Exchange Act in using the deceptive device of placing a "fully paid" certificate on its bonds, establishes the *pari delicto* defense of Petitioners.

Section 10 of the Exchange Act also expressly pro-

hibits use by *any person* of a manipulative or deceptive device or contrivance. The untrue statement on the face of Respondents' bonds clearly falls within this prohibition and the prohibitions of Rule 10b-5.

Although the Court of Appeals held that this untrue statement is immaterial because Petitioners knew the bonds had not been paid for, this amounts to discriminatory enforcement a double standard in interpretation of the law. Respondents' violations of law are held immaterial because of the lack of causation —the lack of reliance by Petitioners on the untrue statements. However, despite absence of causation, Petitioners' technical violation subjects them to most severe penalties.

Elimination of the element of causation would open a Pandora's box subjecting issuers, brokers, dealers, sellers and buyers to immense liabilities for relatively minor misconduct.

It is important that the Supreme Court act to clarify the law as well as to right the injustice to Petitioners.

2. *If issuers are entitled to rescind sales of securities solely because of a purchaser's failure to comply with the registration requirements of the Securities Exchange Act, must they restore to the purchaser consideration paid to the issuers' authorized agent?*

The Court of Appeals overruled the contention of

Petitioners that Respondents ". . . should account for the monies paid to Paden by National but which were not paid to the churches by Paden. This does not follow in light of the voiding provision. The transactions were void *ab initio* and National must account for such of the bonds as were owned by the churches and for which the churches have not been paid." (Appendix B, p. _____).

It is not and has never been the law that a party seeking to set aside a transaction because of violation of the securities laws could deprive the other party of the fruits of the transaction without restoring the consideration received. *Bankers Life & Casualty Co. v. Bellanca Corporation,* (CA 7, 1961) 288 F. 2d 784, 787, cert. den. 368 U.S. 827, 82 S.Ct. 47, 7 L.Ed. 2d 31; *Whittaker v. Wall* (CA 8, 1955), 226 F. 2d 868, 872.

Public policy does not require that every contract involving a violation of the Securities Act is void and unenforceable. *Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 43, 71 S.Ct. 414, 85 L.Ed. 500; *Wood v. Reznik* (CA 7, 1957) 248 F. 2d 549.

In 8 Williston on Contracts (3rd ed. 1964) § 947a, pp. 18-19, it is said:

> "The basic rules with reference to offer, acceptance and consideration, *agency* and fiduciary relationships, interpretation and usage, fraud, il-

> legality, *rescission* and other legal concepts apply to agreements for the purchase and sale of securities." (Emphasis added).

Even when dealing with the intricacies of the securities laws, fundamental rules of jurisprudence apply. An agent is an agent, even though he may also be within the definition of "broker". A corporation is still responsible for the acts of its agents, and it can act *only* through its agents.

There is no question that Paden was the agent of those Respondents who gave him bonds to sell or place.

Paden had actual authority to sell the bonds and collect the proceeds. Since he did not exceed his authority in collecting payment from Petitioners, Respondents, as principals, are responsible for the sums collected by him.

The ruling by the Court of Appeals that Respondents are not to be required to return consideration received by their agent is not only contrary to existing case law, it is shocking to the conscience.

In 3 Loss, Securities Regulation, p. 1628, it is stated:

> "In recission there is no problem of computing damages. Either the plaintiff can restore the defendant to the *status quo ante* or he has no action of rescission at all."

In an analogous case involving a claim of illegality under the anti-trust laws, *Kelly v. Kosuga*, 358 U.S. 516, 518, 520-521; 3 L.Ed. 2d 475, 79 S.Ct. 429, reh. den., 359 U.S. 962, this Court said:

> "As a defense to an action based on contract, the plea of illegality based on violation of the Sherman Act has not met with much favor in this Court. This has been notably the case where the plea has been made by a purchaser in an action to recover from him the agreed price of goods sold. * * *
>
> * * * *
>
> "* * * Past the point where the judgment of the Court would itself be enforcing the precise conduct made unlawful by the Act, the courts are to be guided by the overriding general policy, as Mr. Justice Holmes put it, 'of preventing people from getting other people's property for nothing when they purport to be buying it.' "

Respondents' recovery of their bonds without restoration of the consideration paid to their agent achieves a like result.

Section 29 of the Exchange Act (15 U.S.C.A. § 78cc) upon which the Court of Appeals based its decision, specifically, in § (c)(2), excludes from its purview any attempt to use the Act "to afford a de-

fense to the collection of any *debt or obligation* or the enforcement of any lien by any person who shall have acquired such debt, obligation, or lien in good faith for value without *actual* knowledge of the violation of any provisions of this chapter or any rule or regulation thereunder affecting the legality of such debt, obligation, or lien."

It is undisputed that all parties considered that the securities laws were inapplicable to transactions in church bonds, and that none had actual knowledge of a violation.

The decision that Respondents may recover their bonds and avoid payment of their debts or obligations, by reliance upon this Act is inappropriate under the terms of the Act itself. The laws, where applicable, permit the avoidance of contracts to sell securities, but *there is no intent, inferential or express,* to invalidate the securities themselves or to permit a party to obtain rescission without restoration of consideration received. There is no indication of an intent to penalize a purchaser to a greater extent than a lender.

In a suit involving fraud in the sale of securities, *Smith v. Boles*, 132 U.S. 125, 130, 33 L.Ed. 279, 10 S.Ct. 39, the Supreme Court said:

> " 'The damage to be recovered must always be the natural and proximate consequence of the act complained of;' says Mr. Greenleaf, Vol. 11

§ 256; and 'The test is', adds Chief Justice Beasley in Crater v. Benninger, 33 N.J.L. 513, 'that those results are proximate which the wrongdoer from his position must have contemplated as the probable consequence of his fraud or breach of contract.' "

The rule adopted by the Court of Appeals subjects a party who innocently but mistakenly fails to comply with a technical registration requirement to more far-reaching liability than a party guilty of fraud.

3. *Is the defense of pari delicto available to the purchaser because of false representations in the securities or the failure of issuers' agent to comply with such registration requirements?*

Although the Court of Appeals does not discuss the point, it is manifest that Paden was a broker-dealer within the definitions in the Exchange Act set out in its opinion.

He effected transactions in his customers' bonds as well as regularly buying and selling on his own account. The record is replete with references to Respondents' knowledge that Paden was buying, selling and "placing" bonds.

Those Respondents who insist that Paden had agreed to "place" their bonds for them, cannot disassociate

themselves from the knowledge that he was acting in the capacity of broker.

The only contact Petitioners had with Respondents was through their agent Paden. Petitioners did nothing of which Respondents' broker-agent was not fully aware. Respondents were charged with his knowledge, and the purposes of the Exchange Act were not thwarted by any act of Petitioners.

The whole problem and the entire loss of Respondents arose as a result of the defalcation of their agent —and through no fault of Petitioners.

Respondents placed their negotiable bonds on the market for sale. Petitioners bought and paid for them. No wrong was done by Respondents by anyone except Mr. Paden.

Employment of an unregistered agent to sell securities is as much a violation of the Exchange Act as the failure of a purchaser to register. Respondents would have received much greater protection by requiring their agent to have registered under the Exchange Act than would have been achieved by the registration of Petitioners.

The decision of the Court of Appeals is inconsistent in granting relief to Respondents because of a technical violation of law by Petitioners and ignoring such violations by Respondents and their agent.

Respondents knew their bonds had not been paid for, although they certified on the face of the bonds that payment had been reecived, in violation of the fraud provisions of the securities laws. (Section 10(b) of the Exchange Act and Regulation 10b-5).

In *Can-Am Petroleum Company v. Beck*, (CA 10, 1964) 331 F. 2d 371, 373, a policy appropriate to the instant case is set out:

> "But an investor does not waive or lose the shelter of the Act because he becomes to some extent involved in the illegality of the security sales. * * *
>
> * * * * *
>
> . . . the law differentiates the guilt of the parties, because refusal of relief to the less culpable would involve harmful effects wholly out of proportion to the requirements of individual punishment or the discouragement of illegal contracts."

Culpable conduct existed when Respondents falsely certified their bonds to be fully paid. This coupled with the violations of the securities laws by their agent Paden, lays the blame for loss far closer to Respondents' doors than to the door of Petitioners.

Although the Court of Appeals holds that reliance on the false certificates would be a necessary element

for Petitioners to prove, this position is inconsistent with the court's position on causation discussed above.

False statements are outlawed by the Securities laws in language no less positive than that requiring registration. In fact, the announced purpose of the Securities Laws—to protect investors—would be better served by eliminating the element of reliance upon fraudulent statements than by elimination of the element of causation of injury.

CONCLUSION

The underlying purpose of the Securities Acts is "to protect the naive or uninformed investor and to deny recourse to the reckless or fraudulent seller of securities." *Frost v. Coeur D'Alene Mines Corp.*, supra, 312 U.S. 38, 40, 61 S.Ct. 414, 85 L.Ed. 500, 503; *Wilko v. Swan*, 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed. 168, 173, 175. Such purpose is not furthered by the decision of the Court of Appeals.

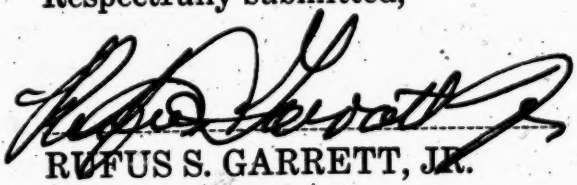
Both Respondents and Petitioners were innocent parties; both were guilty of technical violations of the Exchange Act. The act of Respondents in issuing bearer bonds and delivering them to another with power of sales brings into play the rule, "He who trusts most should lose most". This established maxim of equity is singularly appropriate in this case.

The strained and unnatural construction placed

upon the Securities Exchange Act by the Court of Appeals below is not supported by any interpretation by this Court nor by any principle of law or equity. It is contrary to established jurisprudence.

For the benefit of purchasers of securities in general and broker-dealers in particular, this Court should declare that § 29(b) of the Exchange Act does not vitiate contracts solely because one party has violated some provision of the Act, in the absence of a causal relationship between such violation and the harm suffered by the other party. The decision of the United States Court of Appeals for the Fifth Circuit should be reversed and the decision of the District Court affirmed.

Respectfully submitted,



RUFUS S. GARRETT, JR.

710 Fort Worth National Bank
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ATTORNEY FOR PETITIONERS

GARRETT, GARRETT & CALLAWAY
Of Counsel:

CERTIFICATE

A copy of this Petition for Writ of Certiorari has been served upon Respondents by depositing copies of same, first class mail postage prepaid, addressed to Golden, Burrow, Potts & Boeckman, Attorneys at Law, 2330 Republic National Bank Tower, Dallas, Texas 75201, Counsel of record for respondents.

Attorney for Petitioners

APPENDIX A

FINDINGS OF FACT AND CONCLUSION OF LAWS

(Number and title omitted) (Filed: Nov. 30, 1966)

INTERVENTION OF NATIONAL PLAN, INC.

FINDINGS OF FACT

1. National Plan, Inc. intervened in the above entitled and numbered cause claiming that it was a holder in due course or had been a holder in due course of certain bonds issued by certain Plaintiff Churches.

2. Intervenor prayed for a declaratory judgment that Intervenor took all bonds described in Exhibit A to its intervention as a holder in due course and that none of the Churches issuing said bonds had a valid claim against any of said bonds in the hands of Intervenor or of purchasers from Intervenor.

3. Plaintiff Churches filed a cross complaint against National Plan, Inc. and its president Robert H. Knox, praying for judgment in the amount of $82,700, the value of the bonds sold by National Plan, Inc. and for title and possession to $133,050 of bonds in its possession.

4. The respective Plaintiff Churches issued the

bonds identified in Exhibit A to National Plan, Inc.'s intervention.

5. Each such bond was a negotiable bearer instrument complete and regular on its face, not overdue nor previously dishonored at the time of negotiation to Intervenor.

6. Each bond was duly executed and authenticated.

7. None of the Plaintiffs gave Intervenor notice that there were any reservations, restrictions, encumbrances or claims of any nature affecting the validity of the bonds.

8. Glenn V. Paden, a defendant in the case, was in the business of constructing churches and was assisting the Plaintiff Churches in financing the construction of their churches.

9. Certain of the bonds purchased by Intervenor were sent by the Churches to Paden who had been given authority by the Churches to sell the bonds and to collect the sale proceeds.

10. Neither Paden nor National Plan, Inc. were registered broker or dealers under the Securities Exchange Act.

11. Certain of the bonds were purchased from G. E. Johnson and W. R. McDonald, who were in the

printing business, and advised Intervenor that the bonds had been received as a fee from the Churches.

12. Paden advised Intervenor that certain of the bonds he sold Intervenor were given him as a fee and the others were to finance the construction of the Churches.

13. All of the bonds purchased by Intervenor were at a 10 to 15 per cent discount.

14. Intervenor had had no previous dealings with Johnson or McDonald but had bought other Church bonds from Paden, no question of their validity having been raised and there having been no question of diversion of proceeds.

15. There is no evidence that the bonds purchased from Johnson or McDonald were not received by them as a fee.

16. There is no evidence that the bonds which Paden said he had received as a fee were not as stated.

17. Paden requested Intervenor to make its checks for three transactions payable to World Oil and Gas, who he advised Intervenor would advance money to him as he needed it for construction. There was no evidence that Intervenor knew this statement was false.

18. Other than the purchase of the bonds at a discount and the direction to make checks for three transactions to World Oil and Gas, there is no evidence of any suspicious nature to show bad faith or fraud on the part of Intervenor.

19. There is no evidence that Intervenor had any knowledge that Paden was diverting any of the money received for the bonds to his own use.

CONCLUSIONS OF LAW

1. The Court has jurisdiction of the transaction involved herein.

2. Intervenor normally would have no duty to inquire as to the extent of authority of an agent to negotiate bearer instruments.

3. The existence of unusual and suspicious circumstances of such a substantial character as would indicate a breach of agent's fiduciary duty may put a purchaser upon a duty to make further inquiry.

4. Purchase of the bonds at a discount is insufficient evidence to charge Intervenor with notice of any breach of a fiduciary duty and did not impose a duty of further inquiry upon Intervenor.

5. Purchase of the bonds at a discount is insuf-

ficient evidence to show bad faith or fraud on the part of Intervenor.

6. Paden's direction to Intervenor to make certain checks payable to World Oil and Gas, considering the circumstances, was insufficient to show bad faith or fraud on the part of Intervenor.

7. While the purchase of bonds at a discount and the payment of certain proceeds to World Oil and Gas combined and suspicious circumstances, they are not of such a substantial character as to charge Intervenor with notice that Paden had exceeded his authority, nor are they sufficient to charge Intervenor with the duty to make further inquiry of the Churches as to the extent of Paden's authority.

8. The evidence being insufficient to prove bad faith, there is no violation of the Negotiable instruments Law.

9. The evidence being insufficient to prove fraud, there is no violation of the Securities Exchange Act.

10. The bonds being exempt securities, there was no violation of the registration provisions of the Securities Exchange Act by either Intervenor or Paden.

11. Intervenor not having violated the fraud provisions of the Securities Act, nor having had knowledge of any such violation, the provisions of Section

29 (15 U.S.C.A. sec. 78cc) do not apply to the purchase of the bonds involved herein.

12. National Plan, Inc. is a holder in due course of the bonds involved herein, and Plaintiff Churches are not entitled to either a money judgment or the return of the bonds.

s/ Sarah T. Hughes
U. S. DISTRICT JUDGE

DATE November 29, 1966

JUDGMENT OF THE COURT

(Number and title omitted) (Filed: Dec. 14, 1966)

At Dallas, Texas, in said District on October 7, 1966, the separate issues in the above-entitled action presented by the First Amended Answer & Cross Complaint in Intervention of National Plan, Inc., the denials set forth in the First Amended Answer of the Plaintiffs to the Amended Answer & Cross Complaint of National Plan, Inc. and the allegations in the Second Amended Original Complaint of Plaintiffs referring to said intervenor and its President, defendant Robert H. Knox, and his answer thereto were severed from the remaining issues herein and came on to be heard before the Court, and thereupon, upon consideration thereof, and after argument of counsel and consideration of written briefs filed by plaintiffs, inter-

venor and said defendant, and it being expressly determined that there is no just reason for delay and expressly directed that final judgment upon said separate issues be entered.

The Court is of the opinion and finds:

1. The respective plaintiff churches issued the following duly executed and authenticated bearer bonds:

* * * *

(Listing of bonds omitted)

2. That intervenor acquired each of the above described bonds as a holder in due course.

3. That the securities laws do not invalidate either the bonds in question or the sales here involved.

4. That if any violation of a securities law occurred in connection with the sale of said bonds to intervenor, intervenor participated in no fraudulent act, and any such violation did not materially deny to plaintiff churches any protection which the securities laws were designed to afford.

5. That plaintiff churches are not entitled to either a money judgment against intervenor, National Plan, Inc., or defendant, Robert H. Knox, or to the return of any of the above described bonds.

6. That each of the above described bonds is a valid and subsisting obligation of the issuer.

IT IS THEREFORE, ORDERED, ADJUDGED AND DECREED:

1. That each bond listed above is a valid and subsisting obligation of its issuer.

2. That no plaintiff has a valid claim to any of such bonds or a valid defense to its payment in the hands of National Plan, Inc. or its transferees.

3. That plaintiffs take nothing by their suit against intervenor National Plan, Inc. and defendant Robert H. Knox.

IT IS FURTHER ORDERED, that the Clerk of this court enter a final judgment in favor of intervenor National Plan, Inc. and defendant Robert H. Knox as hereinabove set out, to all of which order plaintiffs excepted in open court.

Dated December 14, 1966.

s/ Sarah T. Hughes
United States District Judge

APPENDIX B

(Heading omitted)

(March 12, 1968.)

Before BROWN, Chief Judge and BELL and THORNBERRY, Circuit Judges.

BELL, Circuit Judge: This case presents the not unusual question of which of the innocent parties, appellants on the one hand and appellees on the other, must bear a loss sustained through the defalcation of a third party with respect to church bonds. The appellants, seven churches, are seeking recovery against the two appellees, National Plan, Inc. and its president and principal owner, Robert H. Knox. The churches, asserting that they never received payment for certain bonds which they issued and which were purchased by National, claim that they are entitled to recover the bonds still in National's possession and damages for any which National has transferred to innocent purchasers. National answers that the bonds are valid and subsisting obligations of the churches. The District Court agreed with National. Unfortunately we cannot finally resolve the question in full. We affirm in part; but, because of a basic error of law in the District Court in the area of securities regulation, the case must be reversed in part and remanded for further proceedings.

I.

The judgment will be affirmed as to two procedural issues. One, the court did not err under the circumstances in severing what forms the subject matter of this appeal from a complex suit involving a total of twenty two churches as plaintiffs, twenty seven defendants and almost two million dollars in bonds. Rule 42(b), F.R.Civ.P., *cf. Rossano v. Blue Plate Foods, Inc.*, 5 Cir., 1963, 314 F. 2d 174; *Fidelity & Casualty Company of New York v. Mills* 5 Cir., 1963, 319 F. 2d 63. The judgment as entered is appealable. Rule 54(b), F.R.Civ.P., *Sears, Roebuck & Co. v. Mackey*, 1956, 351 U.S. 427, 76 S.Ct. 895 100 L.Ed. 1297. Appellee, National Plan, Inc., intervened in the litigation as a defendant and filed a cross claim for declaratory judgment that it was a holder in due course of the particular bonds which the seven appellant churches are seeking to recover or for which they claim damages. Appellants then named appellee Knox as a defendant. The procedure adopted was discretionary and there is nothing to show an abuse of discretion. Moreover no objection whatever was lodged by appellants to the procedure.

Two, the contention that appellants were denied a jury trial is frivolous. They did not seek a jury trial. They made no objection to proceeding without a jury. The idea of a jury trial was first raised in this court through reliance on a request for jury trial

made by two of the defendants who are not involved in the cause before us.

The judgment will also be affirmed on one substantive question. The churches charged appellees generally with participation in a conspiracy to defraud them in violation of § 17(a) of the Securities Act of 1933, 15 USCA, § 77q(a), and certain named sections of the Securities Exchange Act of 1934.[1] This charge was over and above charges of individual fraud, contained in another part of the complaint and to be hereinafter discussed, based on alleged violations of Rules 15c1-4 and 15c2-4 promulgated under the Securities Exchange Act. The District Court found that there was no evidence of fraud on the part of appellees in the questioned transactions. These findings are not clearly erroneous and there the matter ends insofar as the general charge of a conspiracy to defraud is concerned.

II.

This leaves for decision whether appellees or either of them are liable to the churches, or any of them, by reason of the breach as claimed of an additional section of the Securities Exchange Act, § 15(a)(1), or of the rules promulgated thereunder, Rules 15c1-4 and 15c2-4, *supra*. National Plan proceeded for declara-

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[1] §§ 10(b) and 15(c)(1) of the Exchange Act, 15 USCA, §§ 78j(b) and 78o(c)(1), and Rules 10b-5 and 15c1-2 thereunder, 17 CFR§240, 10b-5, 15c1-2.

tory judgment on the premises that the bonds were exempt from regulation under the securities law; hence National Plan was exempt from registration, and that it need only show that it was a holder in due course to establish that the churches were obligated on the bonds.

The District Court concluded that the bonds were exempt securities under the Exchange Act and that there was no violation of the registration provisions of that Act by National. In addition, the judgment provides if there were violations of any securities law in connection with the bond transactions, they did not materially deny the churches any protection which the law was designed to afford. As will be seen, these two holdings are incorrect and require reversal. The Securities Exchange Act pervades the entire case and the transactions involved.[1a]

This brings us to the pertinent facts. National acquired the bonds in the following manner. Paden, a church contractor, agreed to construct buildings for each of the appellant churches. To finance the construction of the buildings, the churches issued bearer bonds to Paden, either selling them to him outright or delivering them to him as agent to sell, or as the church witnesses said, "to place" the bonds on behalf of the churches. The churches claim that Paden was obligated to remit to them the full face value of

[1a] The court sought and obtained supplemental briefs after argument from the parties as well as amicus curiae briefs from the Securities and Exchange Commission.

the bonds, without commission, either promptly or, in the case of certain bonds, as the money would be needed for construction of the buildings. Paden sold bonds in the face amount of $215,750 to National at a discount. In the case of a few the discount was ten per cent; in the case of most, fifteen per cent. National, as directed by Paden, paid for the bonds either directly to Paden or to a company called World Oil & Gas of Delaware, Paden having told National that World Oil & Gas would absorb the discount and pay Paden the full face value of the bonds as he needed it for the church construction projects. The evidence was that Paden failed to remit to the churches on the National purchases.

The churches entrusted Paden with the bonds. They issued the bond in negotiable form. They printed on the face of each bond: "This is a bearer bond and as such may be transferred by delivery". In addition, each bond bore the certificate that payment had been received for the bond but, of course, with respect to those bonds purchased by National on the representation from Paden that he was acting as agent for the churches in an effort to sell the bonds, National knew that the churches had not been paid.

The churches claim that National purchased the bonds in violation of three provisions of the federal securities laws. First, they assert that National was an unregistered broker-dealer and, accordingly, that National's purchase of the bonds violated § 15(a)(1)

of the Act, 15 USCA, § 78o(a)(1), prohibiting an unregistered broker-dealer from effecting securities transactions. Second, they claim that National violated the antifraud provisions in § 15(c)(1) of the Exchange Act, 15 USCA, § 78o(c)(1), and Rule 15c1-4 thereunder, 17 CFR § 240.15c1-4, by failing to send written confirmations of the purchases to the churhes. Third, they claim that National violated the antifraud provisions in § 15(c)(2) of the Exchange Act, 15 USCA, § 78o(c)(2), and Rule 15c2-4 thereunder, 17 CFR § 240.15c2-4, in that it neither transmitted its purchase payments directly to the churches nor deposited the money in a sepaarte bank account or in escrow account for their benefit. The churches claim that, as a result of these violations, National's purchases of the bonds are void under § 29(b) of the Exchange Act, 15 USCA, § 78cc(b), thus entitling the churches to the relief sought.

We consider first the failure of National to register and the result which ensues because of § 15(a)(1) of the Act.[2] It was stipulated that National had not registered as either a broker or dealer under the Act,

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[2] Section 15(a)(1) of the Exchange Act Provides:

> No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means of instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section.

that the mails were used in the transactions in question and that they took place in interstate commerce.

One church securities exemption is from the registration provisions of the Securities Act of 1933, something not here involved.[3] We are concerned with the Securities Exchange Act of 1934. Section 13(g)(2)(D) of that Act, 15 USCA § 781(g)(2)(D), contains an exemption of church bonds, but that exemption, again, relates only to their registration. It does not relate to the antifraud or broker-dealer registration provisions. There is simply no exemption in the Exchange Act from these provisions even when the broker or dealer is handling church bonds.

The District Court did not decide whether National was a broker or a dealer within the meaning of the Exchange Act. This question was not reached due to the erroneous view that church bonds were exempt securities even for the purposes of the broker-dealer registration provisions. Section 3(a)(4) of the Exchange Act, 15 USCA § 78c(a)(4), defines a broker as any person engaged in the business of effecting transactions in securities for the account of others. The evidence shows conclusively that National was a broker. Mr. Knox testified that the principal business of National was to "put on bond issues to build churches". He stated that National went to churches

[3] Section 3(a)(4) of that Act, 15 USCA, § 77c(a)(4), the exemption provision, is made expressly inapplicable to the antifraud provisions of that Act by § 17(c), 15 USCA, § 77q(c), supra.

where they had been requested to put on bond programs, assisted the church in doing all of the legal work concerning the bond program, took care of necessary printing, handled all of the paper work in connection with the bond issue, acted as fiscal agent and trustee of the property, and directed the bond sales program. He testified that the sales were made throughout the country.

Section 3(a)(5) of the Exchange Act, 15 USCA, § 78c(a)(5), defines a dealer as any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. The evidence demands a finding that National was so engaged. National purchased many church bonds prior to the ones in question for its own account as a part of its regular business and sold some of them. Thus National was a broker and a dealer within the meaning of the Act. See 2 Loss, Securities Regulation, 1295, 1297 (2d ed. 1961).

It follows that the purchases which National made from the appellant churches through their agent Paden were in violation of § 15(a)(1) of the Exchange Act, *supra*. The question next arises whether appellants may void these transacteions because National acted in violation of § 15(a)(1) of the Act. Section 29(b) of that Act, 15 USCA, § 78cc(b), *supra*, provides that "every contract made in violation of any provision of this chapter or any rule or regulation thereunder . . . shall be void . . . as regards the rights

of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract . . .". There are certain exceptions to this voiding provision but none is applicable here. Section 29(b) also contemplates civil suit for relief by way or rescission and damages where the transactions are void. *Osborne v. Mallory*, S.D. N.Y., 1949, 86 F. Supp. 868, 879; *Kardon v. National Gypsum Company*, E.D. Pa., 1946, 69 F. Supp. 512, 514; *Geismar v. Bond & Goodwin*, S.D. N.Y., 1941, 40 F. Supp. 876, 878; and see dictum in *Goldstein v. Groesbeck*, 2 Cir., 1944, 142 F. 2d 422, cert. den., 323 U.S. 737, 65 S.Ct. 36, 89 L.Ed. 590.

Without more, it appears that appellants may void these transactions but National contends that appellants are nevertheless not entitled to relief unless they can establish that any harm which they suffered was caused by National's failure to register. See Restat. of Torts, (2 Ed.), § 286. However, the Act requires only that appellants be in the class of persons whose interest the Act was designed to protect. *Cf. Hooper v. Mountain States Securities Corporation*, 5 Cir., 1960, 282 F. 2d 195, 200-202. In our view a more stringent requirement would be contrary to the express mandate of § 29(b).

Under § 15(a)(1), National was prohibited from effecting the transactions here involved and thus violated the Act by entering into those transactions. Un-

der the voiding provision of § 29(b), it is sufficient to show merely that the prohibited transactions occurred and that appellants were in the protected class. We have found no case precisely in point but a similar voiding provision in § 26(b) of the Public Utility Holding Company Act of 1935, 15 USCA, § 79(z)(b), has been construed in accord with our holding. See *Goldstein v. Groesbeck, supra.* The case of *Downing v. Howard,* 3 Cir., 1947, 162 F. 2d 654, 657-678, also involving the Holding Company Act, is not to the contrary; indeed the court there expressly refrained from reaching the question decided in *Goldstein v. Groesbeck.* See also 2 Loss, *supra,* pp. 1757-1763, fn. 248.

The harsh remedy which this view dictates, even under the circumstances of this case where the churches chose the unfaithful agent, seems to be what Congress intended. The fact that Congress removed certain violations from the voiding sanction of § 29(b) lends support to our construction of § 29(b) in this case. See §§ 29(b), 15(c)(2) and 15(c)(3), 15 USCA, §§ 78o(c)(2) and (3), and 15 USCA, § 78cc (b). The requirement that brokers and dealers register is of the utmost importance in effecting the purposes of the Act. It is through the registration requirement that some discipline may be exercised over those who may engage in the securities business and by which necessary standards may be established with respect to training, experience, and records. See §§

15(b)(5) and 17(a) of the Act, 15 USCA, §§ 78o(b)(5) and (8) and 78q(a).

Appellees urge that such consequences are inequitable in light of the conduct of the churches in turning the bonds over to Paden as their agent for the purposes of sale and collection of the proceeds therefrom. They contend that the churches should account for the monies paid to Paden by National but which were not paid to the churches by Paden. This does not follow in light of the voiding provision. The transactions were void *ab initio* and National must account for such of the bonds as were owned by the churches and for which the churches have not been paid.

The contention of the appellants that National violated Rule 15c1-4 by failing to send written confirmations of its purchases to the churches is rejected. This rule is not applicable under the facts before us. Rule 15c2-4 is also inapplicable.

III.

Because of our holding that those transactions involving purchases from the churches are void due to National's failure to register, the case must be remanded to the District Court for further findings and conclusions.[4] It is the procedural policy of the

[4] Findings of fact 12 and 16 are to the effect that some of the bonds were received by Paden as fees. The record demonstrates that none of the bonds in litigation fall into this category and thus these findings, although immaterial, would seem to be clearly erroneous.

federal appellate courts, where disputed issues are involved, that findings of fact and conclusions of law be made in the District Courts. Rule 52(a), F.R. Civ.P., *Kelley v. Everglades District*, 1943, 319 U.S. 415, 421, 422, 63 S.Ct. 1141, 87 L.Ed. 1485; *Mladnich v. United States*, 5 Cir., 1967, 371 F. 2d 940; *Employer's Liability Assurance Corporation, Ltd. v. Weedeen*, 5 Cir., 1960, 274 F. 2d 809; *Victory Towing Company, Inc. v. Bordelon*, 5 Cir., 1955, 219 F. 2d 540. These may be made on the same record or on the record as supplemented, all in the discretion of the District Court. *Cf. Kelly v. Page*, 5 Cir., 1964, 335 F. 2d 114, 118.

Some additional questions will arise on remand. Without in anywise limiting the number of those questions, it does appear that National would not be liable to the churches on any transaction where no privity of contract existed between the church and National. This is on the theory that the church would be a stranger to the transaction. See *Natkin v. The Exchange National Bank of Chicago*, 7 Cir., 1965, 342 F. 2d 675. No evidence whatsoever was offered to show that the churches were anything more than strangers to the transactions wherein National purchased $18,500.00 in bonds from Johnson and McDonald on the representation that they had obtained the bonds as fees for printing. We think it proper to excise this amount from the case at this time since there is no dispute whatever concerning these facts.

It also follows from the privity rule that National will be liable only on those purchases which were made from Paden acting for the appellant churches and not from Paden individually. In two instances, representatives of the churches testified that they sold the bonds to Paden. Paden disputed this and thus the District Court must make specific findings of facts in this regard.

Another question for the District Court is the liability, if any, of appellee Knox. This question has not been briefed. Indeed, it has not been mentioned. On the trial, counsel for appellees stated that the same issue was presented as to National and Knox: Whether National Plan was a holder in due course. There has been no inquiry whatever into what liability would attach to Mr. Knox individually or as president of National in the present posture of the case.

Likewise, we do not reach any question of damages which may exist by reason of the difference in the face value of the bonds and any discount which the churches may have contemplated or any commission which may have been involved for Paden. This is true also as to questions of damages which may exist for any other reasons such as the churches, or any of them, if such proves to be the case, having permitted Paden to keep any part of the proceeds of the sales to National.

AFFIRMED in part; REVERSED in part; RE-

MANDED for further proceedings not inconsistent herewith.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court tha the judgment of the said District Court in this cause be, and the same is hereby, affirmed in part and reversed in part, and that this cause be, and the same is hereby remanded to the said District Court for further proceedings not inconsistent with the opinion of this Court:

It is further ordered and adjudged that the appellants, Eastside Church of Christ, and others, be condemned, in solido, to pay one-half of the costs of this cause in this Court, and appellees, National Plan, Inc., and others, be condemned, in solido, to pay one-half of said costs for all of which execution may be issued out of the said District Court.

March 12, 1968

Before BROWN, Chief Judge and BELL and THORNBERRY, Circuit Judges.

PER CURIAM:

It is ORDERED that the petitioners for rehearing in the above entitled and numbered cause be, and the same are, hereby DENIED.

APPENDIX C

Statutes and Regulations Involved

Section 10 of the Securities Exchange Act, 15 U.S.C. § 78j, provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Regulation 10b-5, 17 C.F.R. § 240.106-5 issued by the Securities Exchange Commission pursuant to said statute, provides in part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instru-

mentality of interstate commerce, or of the mails ....

* * * * *

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . ."

Section 15(a)(1) of the Securities Exchange Act, 15 U.S.C. § 78o(a)(1), provides:

"No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section."

Section 28a of the Securities Exchange Act, 15 U.S.C. § 78bb(a) provides:

"The rights and remedies provided by this chapter shall be in addition to any and all other rights

and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this chapter shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this chapter or the rules and regulations thereunder."

Section 29(b) of the Securities Exchange Act, 15 U.S.C. § 78cc(b) provides in part:

"Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right there-

under with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: PROVIDED, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 78o of this title ..."

Section 29(c) of the Securities Exchange Act, 15 U.S.C. § 78cc(c) provides:

"Nothing in this chapter shall be construed (1) to affect the validity of any loan or extension of credit (or any extension or renewal thereof) made or of any lien created prior or subsequent to June 6, 1934, unless at the time of the making of such loan or extension of credit (or extension or renewal thereof) or the creating of such lien, the person making such loan or extension of credit (or extension or renewal thereof) or acquiring such lien shall have actual knowledge of facts by reason of which the making of such loan or extension of credit (or extension or renewal thereof) or the acquisition of such lien is a violation of the provisions of this chapter or any rule or regulation thereunder, or (2) to afford a defense to the collection of any debt or obligation or the enforcement of any lien by any person who shall have acquired such debt, obligation, or lien in

good faith for value and without actual knowledge of the violation of any provision of this chapter or any rule or regulation thereunder affecting the legality of such debt, obligation or lien."

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In the

Supreme Court of the United States

OCTOBER TERM, 1968

[redacted] 391

NATIONAL PLAN, INC., ET AL.,
Petitioners,

v.

CHURCH OF CHRIST OF ECORSE, MICHIGAN, ET AL.,
Respondents.

[redacted] PETITION FOR WRIT OF CERTIORARI [redacted]

GOLDEN, BURROW, POTTS & BOECKMAN,
WILLIAM BURROW,
2330 Republic National Bank Tower,
Dallas, Texas,
Attorneys for Respondents.

"'It requires but little appreciation * * * of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry." Mr. Justice Goldberg in *SEC v. Capital Gains Bureau*, 375 U.S. 180, 11 Fed. 2d 237 (1963).

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In the

Supreme Court of the United States

OCTOBER TERM, 1968

No. 282

NATIONAL PLAN, INC., ET AL.,

Petitioners,

v.

CHURCH OF CHRIST OF ECORSE, MICHIGAN, ET AL.,

Respondents.

REPLY BRIEF TO PETITION FOR WRIT OF CERTIORARI AND CROSS-PETITION FOR SUCH WRIT

To Said Honorable Court:

Respondents, Church of Christ of Ecorse, of Ecorse, Michigan, Everman Church of Christ of Everman, Texas, Laurel Street Church of Christ of San Antonio, Texas, Church of Christ of South Haven, of South Haven, Michigan, Vaughn Hill Church of Christ of Wood River, Illinois and West End Church of Christ of St. Louis, Missouri, file this Reply Brief to the Petitioners' Writ of Certiorari, and Cross-Petitioners', Ecorse and Everman Churches, file their Cross-Petition for a Writ of Certiorari to review the case below.

REPLY BRIEF

Opinion Below and Jurisdiction

The Petition correctly refers to the opinion below and the grounds on which the jurisdiction of the Court is invoked.

Statutes and Regulations Involved

Applicable Statutes:

Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— * * *
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Section 15 of the Exchange Act, 15 U.S.C. 780:

> "(a) (1) No broker or dealer (other than one whose business is exclusively intrastate) shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, unless such broker or dealer is registered in accordance with subsection (b) of this section."

"(a) (8) No broker or dealer registered under section 15 of this title shall, during any period when it is not a member of a securities association registered with the Commission under section 15A of this title, effect any transaction in, or induce the purchase or sale of, any security (otherwise than on a national securities exchange) unless such broker or dealer and all natural persons associated with such broker or dealer meet *such specified and appropriate standards with respect to training, experience, and such other qualifications* as the Commission finds necessary or desirable." (Italics ours)

Appellees were not members of NASD (Tr. 64).

"(c) (1) *No broker or dealer shall* make use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to *induce the purchase or sale of*, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, *by means of any manipulative, deceptive, or other fraudulent device or contrivance.* The Commission shall, for the purposes of this subsection, by *rules and regulations* define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

"(2) No broker or dealer shall make use of the mails or of any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange, in connection with which such broker or dealer *engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation.* The Commission, shall, for the purposes of this paragraph, by *rules and regulations* define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious." (Italics ours)

Section 29 of the Securities Exchange Act, 15 U.S.C. 78cc:

"*Every contract made in violation of any provision* * * * and *every contract* * * * the performance of *which involves* the violation of, or *the continuance of any relationship or practice in violation of*, any provision of this chapter or any rule or regulation thereunder, *shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract* * * *.

"Nothing in this chapter shall be construed * * * to afford a defense to the collection of any debt or obligation * * * by any person who shall have acquired such debt, obligation, or lien in good faith for value and *without actual knowledge of the violation* * * *" (Italics ours)

Applicable Rules:

Rule 10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

"Rule 15c1-2(a). Fraud and Misrepresentation

"*(a)* The term '*manipulative, deceptive,* or other fraudulent device or contrivance,' as used in section 15(c) (1) of the Act, is hereby defined to include *any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.*" (Italics ours)

"Rule 15c1-4. Confirmation of Transactions

"The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c) (1) of the Act, is hereby defined to include any act of any *broker or dealer* designed to effect with or for the account of a customer any transaction in, or to induce *the purchase or sale* by such customer of, any security (other than United States Tax Savings Notes, United States Defense Savings Stamps, or United States Defense Savings Bonds, Series E, F and G) unless *such broker or dealer,* at or before the completion of each such transaction, gives or *sends to such customer written notification disclosing* (1) whether he is acting as *a broker for such customer, as a dealer for his own account,* as a broker for some other person, or as a broker for both such customer and some other persons; and (2) in any case in which he is acting as *a broker for such customer* or for both such customer and some other person, either the name of the person from whom the security was purchased or to whom it was sold for such customer and the date and time when such transaction took place or the fact that such information will be furnished upon the request of such customer, and the source and amount of any commission or other remuneration received or to be received by him in connection with the transaction." (Italics ours)

"Rule 15c2-4. Transmission or Maintenance of Payments Received in Connection with Underwritings

"*(a)* It shall constitute a 'fraudulent, deceptive or manipulative act or practice' as used in section 15(c)(2) of the Act, for *any broker or dealer* participating in any distribution of securities, other than a firm-commitment underwriting, to *accept any part of the sale price of any security being distributed unless:*

"(1) the money or other consideration received *is promptly transmitted to the persons entitled thereto; or*

"(2) if the distribution is being made on an 'all-or-none' basis, or *on any other basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs, (A) the money or other consideration received* is promptly deposited in *a separate bank account, as agent or trustee for the persons who have the beneficial interests therein,* until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (B) all such funds are promptly transmitted to a bank which has agreed in writing to hold *all such funds in escrow for the persons who have the beneficial interests therein* and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred." (Italics ours)

To procure a Broker-Dealer license, Section 15(b) of the Exchange Act and the Rules thereunder prescribe detailed application requirements, examinations, and financial worth for registration, and reports and regulation after a license is granted.

Questions Presented

Respondents feel that Petitioners' statement of the questions presented is incorrect, and state them as follows:

(1) Do churches (who entrust their securities to their building contractor who said he would "place" them, but instead misappropriated them and secretly sold them to a "fence" at an excessive prohibitive discount, and seller and buyer were, unknown to the churches, broker-dealers and not registered in violation of the Securities Exchange Act, and combined to divert the proceeds to another conspirator, knowing the churches had not been paid) have a cause of action to declare the sales void under Section 29, without proof that the violations of the Act were the cause of the losses? (Respondents feel the violations were the cause).

(2) Are the issuers limited to rescission, or may they have the full damages for which they prayed?

(3) Is the defense of *pari delicto* available to the churches, where the bonds were held in trust by the contractor to deliver them to no person until payment was received and the proceeds transmitted to them, because a statement on the bonds said they were paid for, when the buyer knew they were not, and when the churches did not know the contractor was a broker-dealer?

STATEMENT OF THE CASE

Respondents consider that Petitioners' Statement of the Case contains inaccuracies. The first sentence is fragmentary and is supplemented and corrected by our fuller statement below. It is more correct to say, as to their third sentence, that Paden did not remit any of the proceeds of the sale of the bonds to any of the churches (R 190). As to the

second paragraph, it is questionable whether Paden ever acted as a principal. He testified he did not (R 184). We think the fifth and sixth paragraphs do not correctly state the rulings of the Court of Appeals. The next to the last paragraph does not, in our opinion, state the fundamental question as no one has any authority to violate the law, and the question is really whether the loss should fall on Respondents who violated no law or on Petitioners who confessedly violated the law. Under the circumstances, we submit for clarity and necessary detail the following statement of our own:

This is a facet of the full case alleged in the Second Amended Original Complaint by the 22 Plaintiff churches (of which 6 are involved in this Petition) which is of a single conspiracy to defraud under Sections 10(b) of the Securities Exchange Act of 1934 and Rule X-10b-5 thereunder, involving also violations of other Acts and Rules. The general scheme was to loot insurance companies by acquiring them with church bonds which were unpaid for, with representations to some of the co-conspirators that they would pay the churches for the bonds with the companies' premium income.

Details as to the facts of this conspiracy will be found in the Complaint at pages 300 and following of the transcript. The conspiracy itself is alleged in Art. IV (R 297).

Glen V. Paden, a church building contractor formerly of good repute, allegedly obtained for World Oil and Gas Corporation of Delaware and other Defendants pursuant to the scheme more than five million dollars in bonds from

churches for whom he was building, usually through the guise separately to each church that he "would place" the bonds. A chart of those so obtained, with the dates, the more than three million dollars of bonds recovered, and the $1,874,695 of bonds still outstanding, appears at pages 302 and 304 of the transcript.

Among those obtained by Paden were $555,650 from the seven churches involved in the hearing below, $215,750 of which he disposed of to Petitioners. It was stipulated at the hearing: "With the exception of West End Church * * * the bonds were handed to Mr. Paden with the understanding and instructions that *he would not deliver possession of them to any person until he received payment of face value for them, which he was to forward promptly to the church involved*" (R 105).

Mr. Paden and Petitioners understood that Paden was an agent to place all of these bonds (R 68, 184). He testified he did not own any of them (R 184) and that he did not tell Petitioners he owned any (R 33). His employees, however, told the Ecorse and Everman churches Mr. Paden was buying the bonds. Petitioner National Plan, Inc., through its sole manager and controlling officer, Petitioner Knox (R 29, 70) purchased the $215,750 in bonds involved, $8500 at 10% discount below face value, $22,000 at 15% discount, and later $150,750 at 16.51% discount, and $34,500 at 16.88% discount.

Petitioners paid for the above $150,750 of bonds with checks to another Defendant, World Oil and Gas Corporation. It is not controverted that Mr. Paden told Petitioners: that the churches had not been paid for any of the bonds (R 179-180, 198); that the checks to World Oil was a loan for which World Oil was to pay a prohibitive penalty by absorbing the discount for the short time use of the money, until repaid by Paden and World Oil to the churches when the money would be needed for construction (R 56, 179-180, 182, 195, 196, 199); and that this money from the sale was to help them "get started" (R 200) (on the scheme). Although Petitioners considered Mr. Paden the agent for the churches (R 68), they did not confirm the transactions to the churches (R 76) or contact them in any way for months (R 73-75).

It is conceded that both Paden and the Petitioners were Broker-Dealers, and unlicensed in violation of the Securities Exchange Act. The churches remained in complete ignorance of these transactions and of the transactions of each other, wanted their money, and would have objected if they had known (R 208-9). Petitioners, however, knew of Paden's vast transactions (R 185), but the churches did not and none of them knew that its contractor was a Broker-Dealer (R 107, 117-118, 130, 135, 149, 152, 164).

Petitioner Knox had been an automobile salesman until less than a year before these transactions began and had had no experience in securities (R 59-60). Petitioners

effected actions in bonds for churches throughout the country (R 29, 30, 61, 62). The Petitioner company owned $185,400 in bonds when Mr. Knox bought it in 1964 (R 60) and disposed of them. It began buying and selling other bonds on its own account, after Mr. Knox purchased it, at least as early as January 1965, and bought a total of $271,120, including those of the Respondents by July 28th, 1965. Petitioners bought the Appellants' bonds for resale, sold $82,700 of them, and held $156,800 for sale (R 20, 55, P1. Ex. 1). The financial statement is weak (P1. Ex. 1); all the purchases were made 100% on borrowed money (R 66), with the bonds pledged to a bank (R 15)—an innocent purchaser. At the time of hearing, Petitioners still had no Broker-Dealer License, though advised by the SEC and their own lawyers that they should have one (R 51-52).

Respondents, though gullible and lulled by Petitioners and the other Defendants, became more and more impatient, discovered the scheme, and brought this lawsuit January 8, 1966. The Petitioner company intervened the following summer asking for declaratory judgment that its bonds were good against Respondents. Respondents replied, impleaded Petitioners as Defendants in the main suit as in violation of Sections 10 and 15 of the Exchange Act, and Rules X10b5, 15c1-2, 15c1-4, and 15c2-4 thereunder, and asked for restoration of the bonds or damages (R 315-318, 285-292).

Reasons For Not Granting Petitioners' Writ

Sec. 2 of the Securities Exchange Act (15 U.S.C. 78b) states that transactions in securities are "affected with a national public interest * * * making it necessary to provide for (their) regulation and control * * * to require appropriate reports and to impose requirements necessary to make such regulation and control reasonably complete and effective". Moreover, most transactions occur over the counter, and four-fifths of all bond transactions such as those involved in this case occur there (*Loss*, Sec. Reg. (2d Ed.) 1284-1286). Where there is no "registration" by the Brokers and Dealers who conduct these operations there can be no "appropriate reports" and no "requirements necessary" for "regulation and control". Where there is such a black market for stolen securities, thefts and frauds abound. Congress provided the remedy for failure to register by Sec. 29 of the Act (15 U.S.C. 78cc) and the Court of Appeals has enforced it in this case as to several churches whose bonds were misappropriated, and we trust this Honorable Court will uphold that decision.

The Court below was of the opinion that the huge loss should fall upon the Petitioners who violated the Act and not upon the Respondents who did not violate it. It held that Respondents' remedies were not limited to rescission but they could have their full damages, and held by implication certainly that Mr. Paden, a fiduciary trusted to obey the law, was without authority from Respondents to violate the law.

ANSWER TO PETITIONERS' ARGUMENT AMPLIFYING ITS REASONS

1. It has been pointed out above that the Petitioners' statement of this question as to causal relation is inaccurate, and we phrase it, we think, properly on page 7 above.

The whole argument of Petitioners is tied to the past. They tried the case, as appears from the record, on the theory that the securities laws did not apply and that it was a case under the Negotiable Instruments Law. The Trial Judge agreed, holding that because the securities were exempt from registration so also were those who traded in the securities, and, apparently, held further that since there was no common law fraud, there was no Securities Exchange Act fraud. We think that in their argument on causal relations, Petitioners hold to the old arguments.

The distinguished Judge Charles Clark held in *Goldstein v. Groesbeck*, 142 F. 2d 422, (2 Cir., 1944, Cert. Den., 323 U.S. 737) that a public utility holding company which refused to register under the Public Utility Holding Company Act of 1935 (15 U.S.C. 79), had to account to its subsidiaries for its profits under service and construction contracts. Sec. 26(b) of that Act (15 U.S.C. 79z(b)) is almost identical as the Court says, at 427, with Sec. 29 of the Exchange Act (15 U.S.C. 78cc). Judge Clark said that "Sec. 26 is incomplete, is not ineffective unless it is considered to authorize recovery by the operating companies."

The *Goldstein* case was one of overriding public concern, as is this case in that the maintenance of an honest market and an end to frauds and swindles such as have occurred here is a matter of great importance to public welfare. To require that all Broker-Dealers dealing in securities should be licensed, controlled, made to take the training and held to the standards of honesty and accounting that registration requires, as Congress has done, is similar to the requirement of registration of public issues and, for that matter, to the requirement that a bank be chartered. To provide a remedy by voiding the contracts of the violators is no more severe than to provide a remedy for false and misleading statements or to make an unchartered bank return money. Without that remedy the vast over the counter market cannot be controlled because, just as Mr. Justice Clark pointed out in *J. I. Case v. Borak*, 377 U.S. 426 (at 432), 12 L. Ed. 2d 423 (at 428), "the possibility of civil damages * * * serves as a most effective weapon". No government commission can do so without the supplement of private action; and who can say that Respondents' losses would have occurred had there been only an honest market. Where but at a bucket shop could $215,750 of securities be sold with the dealers "spread" in the form of a prohibitive discount such as condemned in the famous *Shingle* case *Hughes & Company v. S.E.C.*, 139 F. 2d 434 (2d Cir. 1943, Cert. Den. 321, U.S. 786)?

Furtherfore, there was the failure of Petitioners to confirm to Respondents, and their combination and conspiracy with Paden in diverting the proceeds of the sale, which

we argue in our own Cross-Petition below. It seems to us that there was sufficient causation, and that even if there were not, the statute is specific in its statement that the contract shall be void.

We disagree with the Petitioners' argument that the claim is one in tort. Vitiating a contract is a claim in contract and not tort. We, therefore, think Petitioners' argument citing the cases of *List v. Fashion Park, Inc.*, 340 F. 2d 457, (2d Cir., 1965, no App. for Cert.); *Vine v. Beneficial Finance Company*, 374 F. 2d 627, (2d Cir., 1967, Cert. Den. 389 U.S. 970); *Smith v. Bear*, 237 F. 2d 79 (7th Cir., 1956, no App. for Cert.); and *Boone v. Baugh*, 308 F. 2d 711 (8th Cir. 1962, no App. for Cert.) are confusing but not helpful. They are all Rule X10b5 cases and, of course, all fraud cases which, even though the rule expands and liberalizes common law fraud to meet the intricate needs of today, still sound in tort. The Ben Jack Cage case, *Hooper v. Mountain States*, 282 F. 2d 195, (5th Cir., 1960, Cert. Den. 365 U.S. 814) was also a X10b5 case and went the other way and held, apparently, that in cases of mammoth fraud, causation is self-evident.

Loss, Sec. Regs. 1765-6, discusses the question of reliance under X10b5 cases.

Ours is not that kind of a case but a statutory contract case. It is logical and a harmonious theory that causation is not essential under the restricted Section 29 contract cases but is an essential element under the crime-tort fraud cases. Thus, similarly under Sec. 12(2) of the 1933 Act (15

U.S.C. 771) in sales with misleading statements, causation is not necessary, *Loss*, Sec. Regs. (2d Ed.) 1702, *Woodward v. Wright*, 266 F. 2d 108, (10th Cir. 1959, no App. for Cert.)

Petitioners' reference to Sec. 28(a) (15) U.S.C. 78bb) does not seem relevant as the section is only to prevent double damages, which are not sought here.

The references to the Congressional Record on pages 12-14 of Petitioners' Application are not, in our opinion, material as the debate concerned Sec. 18 of the Exchange Act (15 U.S.C. 78r), which concerns applications and reports to the Commission, and specifically provides for reliance and good faith.

2. Petitioners' argument that Respondents are limited to the remedy of rescission only is not, in our opinion, sound. We asked specifically for restoration of the bonds and for full damages (R 317-318). Furthermore, it is in direct conflict with the holding of *Hooper v. Mountain States*, supra and with the case of *J. I. Case Company v. Borak*, supra where the Court states "We, therefore, believe that under the circumstances here it is the duty of the Courts to be alert to provide such remedies as are necessary to make effective the Congressional purpose" (377 U.S., at 433; 12 Law Ed. 2d, at 428). Furthermore, how could the churches restore what they never received, and which Petitioners made it impossible for them to receive by conspiring and combining to divert the proceeds to another Defendant?

3. Respondents contend that the question as stated by Petitioners is not a fair one on the record and that the

correct question is that set forth under (3) on page 7 above. On the facts in the case *pari delicto* is simply not an issue. As stated on page 10 above, with specific references to the record, Respondents did not know Paden was a Broker-Dealer and it was stipulated that Paden was not to deliver the bonds to anybody until payment was received (R 105). There is no evidence that any church knew of transactions of the other churches. The delivery of the bonds under such a trust to Paden could not constitute any falsity or misrepresentation. Furthermore, the Court below correctly held that the statement as immaterial, as it was uncontradicted that the Petitioners knew that the bonds were not paid for (R 179-180, 198). Furthermore, as *Hooper v. Mountain States*, supra held, *pari delicto* would not be a defense (*Loss*, Sec. Regs. (2d Ed.) 1797-1804).

RESPONDENTS' CROSS-PETITION FOR WRIT OF CERTIORARI

Respondents, Ecorse and Everman Churches, hereby file their Cross-Petition for review for Writ of Certiorari. To avoid confusion the Cross-Petitioners will hereafter be referred to as "the Churches" and Cross-Respondents as "National".

Time for Cross-Petition

By order of Mr. Justice Hugo Black of July 10, 1968, the time for filing this Cross-Petition was extended until August 10, 1968.

Formal Requisites

The formal matters required by Rule 40, the Statutes and Regulations Involved and the Statement of the Case as to the facts are set forth hereinabove on pages 2-11, and by the Petitioners in their application, all of which is incorporated herein by reference.

Questions Presented for Review

1. Are the Churches precluded from recovery by lack of privity on the contract theory under Sec. 29?

2. If so, may they recover under the crime-tort theory for National's violation of SEC Rule X15c1-4 by failure to confirm, or under Rule X-15c2-4 for National's combining with Paden in his misapplication of funds?

3. Or, may they recover under the crime-tort theory for National's combination and conspiracy in the combination and conspiracy with Paden in the misapplication of funds in violation of Rules X-10b-5 and 15c1-2?

ARGUMENT

1. Granting, as on this record must be done, that all the churches have been swindled and that National violated the law, and granting, as must also be done under the *Borak* case, supra, that the "Federal Courts have the power to grant all necessary remedial relief", it does not seem fair that these two churches should be denied relief by use of the fiction "privity". The only difference between their situation and that of the others is that Paden's employees

told them he was buying the bonds. As specific references to the record on page 9 above show, both Paden and National thought as to these as to the other churches, that he was only an agent to place the bonds. The record shows the Ecorse bonds were received by Paden May 13th and sold to National the next day, and the Everman bonds received by him on July 16th with $19,000 sold on the 19th and the other $21,000 on the 27th. This immediacy and the apparent agency of Paden ought, in common sense, to be sufficient privity, because National's information and actions were exactly the same as with the churches where recovery is allowed. We see nothing in any case we can find, or in any definition of privity, including those in 33 *Words and Phrases* 810, Supp. 250, requiring more.

Yet *Loss*, at page 1759, thinks that for recovery under a contract theory, privity is required, and *Natkin v. Exchange Bank*, 342 F. 2d 675 (7th Cir. 1965, No App. for Cert.) talks about lack of privity. The holding, however, is not in point. The bank Defendant there was not at fault in any way whatsoever, taking securities pledged in violation of the margin requirements without any knowledge of the violation. National here is violating the law and we have not even joined, as a party, the bank to which he pledged the securities. The *Natkin* decision would have been the same without the privity dictum.

Furthermore, Section 29(b)(2), while perhaps not specifically applicable here, shows that the Act does intend recovery against a Defendant "not being a party to

such contract" with knowledge of the violations. In any event, we contend there was sufficient privity under the contract theory and, if not, the fiction ought to be abolished, as has been done anyway by what Professor Loss describes as "implied liability" under the crime-tort theory (on the same page 1759).

2. Here we contend on the second question that National is on the horns of a dilemma. Under the provisions of Rule X15c1-4, if Knox, its sole manager, understood Paden was only an agent, he was bound to confirm the transactions to his principal. This is the clear provision of the rule and the Commission so interprets it (*In the matter of Alex Smith*, 30 S.E.C. Reports 13 (1946)). He did not confirm, in the case of Ecorse, from May 14th to November 1st, and in that of Everman from July 19th until the latter date.

The other horn of the dilemma, and this is the one the proof shows, is that if he knew Paden was also a Broker-Dealer he knew that Paden was violating Rule 15c2-4. The proceeds were not being promptly transmitted to the Churches who were entitled thereto or put in a bank account in trust for them as the Rule requires. Knowing of Paden's vast transactions (R 185) and that Paden was an agent (R 68, 184), did not own the bonds (R 184), that the Churches had not been paid (R 179-180, 198) and of its own huge purchases from Paden, National was bound to have known Paden was a Broker-Dealer.

By the proviso that was added to Sec. 29(b) by the amendment of 1938, violations of these rules were excluded from express liability under Sec. 29, that is to say, under the void contract theory. The Court below felt that the rules were thus not applicable but this is, we think, a *non sequitur*. The rules would have no meaning whatsoever if there were not some penalty for violation. Recovery can and should be allowed under the crime-tort theory that the disregard of the command of a statute is a wrongful act and a tort as stated in another connection in *Texas & Pacific Railway v. Rigsby*, 241 U.S. 33, 39: "This is but an application of the maxim, *Ubi jus ibi remedium.*" This is what Professor Loss describes as "implied liability" (1763-1771) and was first advanced in S.E.C. Rule X10b-5 cases in *Karton v. National Gypsum*, 69 F. Supp. 512 (E.D. Pa. 1946) and culminated in the *Borak* case supra.

Under the crime-tort theory all difficulties of privity disappear (*Loss*, 1763-71, *Hooper v. Mountain States*, supra; *Errion v. Connell*, 236 F. 2d 447 (9th Cir., 1956); *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 85 L. Ed. 180 (1940)). The language of the latter case was quoted with approval in the last paragraph of 377 U.S. at 433 in the *Borak* case. The old common law concepts, according to Mr. Justice Goldberg, are not suitable to present day transactions in the intricate securities field (*SEC. v. Capital Gains Bureau*, 375 U.S. 180 11 L. Ed. 237 (1963)).

Moreover, under the crime-tort theory, problems of causation disappear, not only as to the two church Cross-Peti-

tioners but as to the other four churches involved as well. The chain of causation is full and complete. It is as follows:

(1) Possession secured by Paden illegally.

(2) Unlawful sale to unregistered Broker-Dealer at black market discount, who knew bonds were not paid for and Paden to be the Churches' agent.

(3) Sale was without authority to sell by Seller to Buyer without authority to buy, because of violations of the Securities Acts.

(4) Wrongful combination and conspiracy in misappropriation with a loan at exorbitant interest to another conspirator, knowing that prompt payment was not being made to the Churches entitled thereto.

(5) Causing liability of the Churches to innocent purchasers.

Failure to confirm could be inserted in lieu of the knowing participation and conspiracy to misappropriate, although proof of the conspiracy in violation of Rule X15c2-4 is in the record.

3. The facts stated and argued in 1 and 2 above also constitute violations of Rules X10b-5 and X15c1-2(a). These violations were alleged by the Churches (R 289, par. VII; 297, par. IV) but were not argued in the Trial Court because of a procedural tangle, nor in the Court of Appeals because reversal was sought for the precedural error that the issues on these two rules were not tried. The Court of Appeals has held, however, that they were tried, and the Churches are now, therefore, at liberty to argue that National's actions violated these Rules.

The ready market afforded the admitted swindler Paden by National, the excessive discounts paid on an increasing scale as time went by, the lack of registration, the knowledge that the bonds were not paid for, the loan of the proceeds to another conspirator who would pay exorbitant interest, the knowledge that the proceeds were not being transmitted to the Churches, the operations on 100% borrowed money, the immediate pledge of all the bonds, and quick resale at or near face value, may not constitute common law fraud as the Court found, but in the light of all the cases cited herein, are a part of one of the largest "frauds or deceits" on record in this country and constitute violations of the rules cited.

WHEREFORE, Respondents pray that the Petitioners' Application for the Writ be denied and that Cross-Petitioners' Application be granted.

GOLDEN, BURROW, POTTS & BOECKMAN,
WILLIAM BURROW

Wm. Burrow

Attorneys for Respondents and Cross-Petitioners

August 7, 1968

Copy this day mailed Receiver, Securities & Exchange Commission, *amicus curiae*, and Attorney for Petitioners.

WILLIAM BURROW